José De Gregorio: Policy responses to the global crisis

Presentation by Mr José De Gregorio, Governor of the Central Bank of Chile, at the conference "Monetary Policy and Central Banking in the Post Crisis Environment", Santiago, 17 January 2011.

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In the last years economic policymakers have had to deal with many unprecedented challenges. The severe inflationary shock that began in 2007 was followed by the worst financial crisis since the Great Depression and the deepest worldwide economic recession in the postwar period. Currently, even though recovery is underway, the rebound in economic activity has been characterized by a dichotomy: whereas emerging countries are posting strong growth rates, in the developed world activity is sluggish, with high unemployment rates and excess capacity. This bifurcated economic scenario has brought many tensions to the global economy.

In Chile, to the shocks that have affected the world economy in this period, one has to add the earthquake and tsunami that hit our country almost a year ago and that had both short and medium-term effects on our economy.

One of the main lessons we have learned these years is the importance of having a robust policy framework. In the case of Chile, institutional developments, low level of public debt and high availability of liquidity allowed unusual vigor in monetary and fiscal policy to confront the negative effects on demand and output of all the shocks that have affected us. Macroeconomic stability was preserved and performance of the Chilean economy was much better than in previous world recessions (figure 1). Also, the financial system endured the global financial crisis with no setbacks, no systemically important financial institutions experienced major stress, and macroeconomic policies set the stage for the healthy recovery we are witnessing now.

The macroeconomic framework of the Chilean economy was very important in attaining these results. This framework rests on four pillars. First, monetary policy management is based on a flexible inflation-targeting regime, conducted by an autonomous central bank and supported by a floating exchange rate system. The inflation targeting scheme considers a 3% annual inflation target, with a two-year horizon to correct deviations and a ±1 percentage point tolerance range.[1] The floating exchange rate regime includes the possibility of intervening in the foreign exchange market under exceptional circumstances, which has happened four times since September 1999. Second, a fiscal policy that is accountable and predictable thanks to a structural balance rule.[2] The significant amount of savings accumulated during the run-up of copper prices was a crucial factor in bolstering the resilience of the Chilean economy and in providing a countercyclical fiscal boost. Third, a high degree of commercial and financial integration with the rest of the world. Although copper still accounts for a relevant portion of Chilean exports, an important number of new markets for a variety of products have been opened thanks to both the unilateral efforts of trade liberalization and the significant spread of bilateral trade agreements with the major economic countries and zones. Finally, a sound financial system, with globally integrated, well-capitalized, and adequately-regulated banks. Actually, the regulation of the domestic banking system prevented some of the most notorious credit excesses that happened in advanced economies, or in the past of many emerging markets, including Chile.

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[1] Banco Central de Chile (2007).

[2] See Marcel et al. (2001) for a discussion of the budget rule.

I will continue my presentation speaking about how all the shocks we have seen the last few years have affected the Chilean economy and the policy responses we have put in place. Then I will describe the recovery process and I will finalize presenting some thoughts on the lessons that can be drawn from our recent experience and some challenges I see for the future.

The run-up to the financial bust

By March 2008, Bear Stearns had already gone bankrupt and the risk of a higher stress episode at the world financial markets had increased greatly. Due to the risks of a potential sudden stop if the financial crisis should worsen, and in a context of a severe appreciation of the Chilean peso, in April, the Central Bank decided to start accumulating reserves through sterilized intervention.

In Chile, domestic demand grew rapidly in the run-up to the crisis. During 2004–2007, the average annual growth of output was 5.3%, while the average growth rate of domestic demand was 8.1%. Private consumption grew 7.2% and investment 12.1%. The faster growth of demand than output is explained by a significant improvement in our terms of trade on the back of higher prices for copper and other commodities.

In 2007, Chile, like many other economies in the world, suffered a significant inflationary process, which only worsened during 2008 (figure 2). Perhaps the most remarkable component of this inflationary process was how strongly the increase in international food prices was transmitted domestically. This may have partially been due to Chile's high degree of commercial openness and little distortions in the price setting mechanism. Another factor underlying inflation pressures, and a deceleration of growth, was the higher cost of energy (especially electricity) that hit the Chilean economy with particular strength (figure 3). Not only thermoelectric power plants had to operate with more costly inputs, but also unfavorable hydrological conditions and a severe shortage of natural gas implied that these more efficient sources of generation had to be replaced by diesel, in the context of rising oil prices.

Inflation rose from an annual rate of 2.6% in December 2006 to 9.9% in October 2008, when the rise of food and energy prices had also propagated to the rest of consumer goods. Hence, the risks of inflation remaining above the target beyond the policy horizon grew strongly. Consistently, monetary policy had a strong reaction. The Monetary Policy Rate (MPR) was increased by 200 basis points in just four months, starting in June. By September 2008, before the collapse of Lehman Brothers, the Central Bank estimated that it would be necessary to increase the MPR further, even above market expectations.

Monetary and fiscal policy during the crisis

As in most of the world economies, financial tensions in Chile were severe after the collapse of Lehman Brothers. Interest rates in both peso and dollar markets posted substantial increases in the most stressful times from mid-September to mid-October 2008 (Figure 4). The Central Bank acted quickly, providing peso and dollar liquidity facilities to the financial system to mitigate liquidity tensions, but also to ensure financing in foreign currency should foreign loans become scarce. Also, the foreign exchange reserves accumulation process was cancelled. Local money market conditions normalized rapidly, over a period of weeks. The additional liquidity facilities put in place were not used extensively by financial institutions, reflecting their sustained access to external markets.

Beyond the stressful episodes in local money markets, the global confidence crisis that swept around the world was very important in Chile. The events of developed financial markets prompted a deep and widespread revision of investment and spending plans of businesses and households, bringing expenditure to a halt. Domestic demand and economic activity dropped significantly and lending standards tightened (figure 5).

The inflation outlook changed radically, and monetary policy reacted forcefully. First, by communicating a change in outlook and the bias of monetary policy, inducing an important decline in market rates at all horizons. Then, in January 2009, with a clearer assessment of the reduced inflationary pressures, the MPR was lowered by 100 basis points. Later, with the evidence of alleviated inflationary pressures and a sharp contraction in demand, the Central Bank decided to cut the MPR by 250 basis points at both its meetings of February and March. The monetary easing process continued and completed 775 basis points in seven monthly meetings, bringing the MPR to 0.50% in July 2009, the minimum level deemed adequate for a normal functioning of money markets (figure 6). In addition, the Central Bank also announced that the MPR would be held constant at this minimum level for a prolonged period of time. In order to strengthen the commitment to this announcement, which goes beyond the regular monthly MPR setting, the Bank adopted some non-conventional monetary policy measures, extending the overnight liquidity facility for banks at the MPR to 180-day term through a term liquidity facility (Facilidad de Liquidez a Plazo, FLAP). The extraordinary liquidity measures provided during the crisis extinguished in mid 2010 and their withdrawal did not generate stress in the money market.

The shift to a countercyclical policy stance was also taken forcefully on fiscal policy. In January 2009, the government announced a sizable fiscal stimulus package, amounting to US$4 billion for that year, equivalent to 3% of GDP.

The recovery process

The economic recovery was faster than expected. In the second half of 2009, activity grew at an annualized rate of around 6%. Key factors in this trend included the increase in private consumption and the recovery of investment. Initially, the recovery of private demand was due mostly to the rebuilding of inventories, it continued with the dynamism of consumption and gross fixed capital formation. This contrasts with the situation in advanced economies where after inventories recovered, private demand has been sluggish due to the very weak financial position of households. Several indicators available until end February of 2010 were pointing to a consolidation of the consumption and activity trend. But then, on February 27th, the fifth strongest earthquake ever measured hit our country.

The huge initial contraction of aggregate output was largely concentrated in manufacturing. The immediate disruptions of the productive processes due to 27-F dissipated quickly and by the second quarter of the year output exceeded the levels prior to the earthquake. The economy remained on a growth trend and inflation has been below expectations, owing to lower imported inflation and some specific factors. The baseline scenario of our December Monetary Policy Report assumes that the Chilean economy grew 5.2% in 2010 and that GDP growth will stand between 5.5 and 6.5% during 2011. Median private expectation set the growth rate for 2012 at 5.5%. Economic growth projections assume that output gaps are near exhaustion and will stay thus over the whole policy horizon.

The normalization process for monetary policy started in June with a 50 basis point hike and continued the following four months at the same speed. Between October and December the normalization pace was slowed down to 25 basis points. In January the Monetary Policy Rate was kept unchanged, but the Board has stated that it will be necessary to continue to reduce the monetary policy stimulus in the coming months.

But, important risks persist on this scenario. As I mentioned at the beginning of my presentation, the risks in the external scenario are high, especially due to the fact that global recovery has been imbalanced between developed and emerging economies, with high commodity prices, low interest rates, a sluggish recovery of developed economies and a depreciated US dollar. Relevant risks include escalating financial tensions in Europe, persistent high unemployment rates in developed economies and sharper adjustments in some emerging economies that are facing inflationary pressures. Considering this risks and the fact that the real exchange rate had appreciated significantly, the Board of the Central

Bank decided, on January 3rd, to start a program of foreign currency purchases aimed at strengthening its international liquidity position. Thus, the Central Bank will hoard additional international reserves amounting to US$12.0 billion over the year 2011, via periodic purchases of foreign currency until the end of December of 2011. This program will take the Central Bank's international liquidity position to the equivalent of 17% of GDP, which is comparable with those of other economies similar to Chile (figure 7).

The monetary effects of this measure will be sterilized in order to keep a liquidity provision in pesos in the market in line with the target for the monetary policy rate. The hoarding of international reserves entails financial costs for the Central Bank associated to the differential between the return on investments and the cost of financing them. The level proposed for the international reserves is consistent with the Central Bank's financial sustainability, although additional leeway is limited. The initial reaction to this announcement was a nearly 5% depreciation of the peso.

Nonetheless, the intervention does not pursue a specific level for the exchange rate. Our immediate target is to achieve the stated level of reserves, about 17% of GDP, and to alleviate exchange rate tensions. We remain committed to a floating exchange rate system, and the exchange rate will keep floating during the intervention period.

For an economy like Chile, which can encounter significant changes in external financial conditions and in the terms of trade, foreign exchange flexibility is an essential ingredient of its macroeconomic and financial stability. Within a volatile environment like that of the past few years, the inflation targeting regime with a floating exchange rate has displayed its benefits in terms of allowing a smoother trajectory of the Chilean economy. Our floating regime admits interventions in exceptional situations, like the one announced at the beginning of the month.

Nonetheless, it is important to consider that beyond the evolution of the dollar in international markets, there are some more long-lasting elements underlying the real appreciation of the peso, such as improved terms of trade, the accumulated increase in the ratio of public expenditure to GDP and the reduction in our net debtor position relative to the rest of the world. The effects of these factors on the real exchange rate and the competitiveness of some sectors goes beyond the horizon of the effects of this intervention. Those sectors need to improve their productivity and reallocate their exports to growing emerging markets in order to remain competitive.

In any case, additional reserves available will allow to better deal with the contingency of a significant deterioration of the external environment. Foreign exchange markets are under stress and currencies are adjusting asymmetrically. There is also the risk that GDP growth decoupling between advanced and emerging economies will persist longer than expected, thus intensifying the pressure on the exchange rate. Accordingly, the effects of this measure, although temporary, should open room for smoother real adjustments in the domestic economy.

Final thoughts and challenges

The ability of macroeconomic policies in developing economies to react swiftly was essential to reduce the impact of the global crisis. The answer of monetary and fiscal policies and a sound and well regulated financial system were key factors in the ability to withstand and recover from all the hard times we have had to face in the last few years.

The Chilean economy has picked up strongly. Expansionary policies applied have paid off. The current recovery process has posed two main challenges to emerging market economies. The first one has to do with the appreciation of currencies and the resumption of capital inflows. And the second, with the need to control inflation in an environment of rising commodity prices.

Massive capital inflows are not a problem in Chile, as we have a current account surplus; therefore, in net terms we are lending to the rest of the world. In contrast, some other countries see this as a problem as economies grow strongly and current account deficits widen despite gains in terms of trade. Some economies are using capital controls to temper the pressures. Despite the fact that this is not a relevant issue now in Chile, in a longer-term view, the effectiveness of this type of measures has to be carefully evaluated. At least, the evidence for Chile shows that the effects of capital controls during the 1990s were very limited at best.[3]

Overall, the currencies of most emerging and commodity-exporting countries have been appreciating, regardless of the presence of net capital inflows. It is possible to mitigate transitorily its effects on the real economy, but longer-term actions need to be taken to support competitiveness. But, in a world scenario with greater importance of emerging market economies, their currencies will be stronger than in the past. A more balanced recovery of the world economy should alleviate tensions.

Commodity prices have been rising in the last few months, owing to a large extent to the strong growth of emerging market economies. Although they represent supply shocks that change relative prices, and in addition the supply response should mitigate this rise in the longer term, the short-term challenges are significant. The role of monetary policy is to avert second round effects that could contaminate inflation dynamics. For this reason, and in the context of solid growth and closed output gaps, monetary policy should gradually tighten in emerging markets, something we have been doing in Chile.

Today the overall challenge for policymakers is to allow for sustainable growth. The Central Bank will fulfill its purpose and will continue to use its policies with flexibility, as proven in the recent intervention announcement, so that projected inflation stands at 3% over the policy horizon. This is the best contribution the Central Bank makes to Chile's welfare and growth potential.

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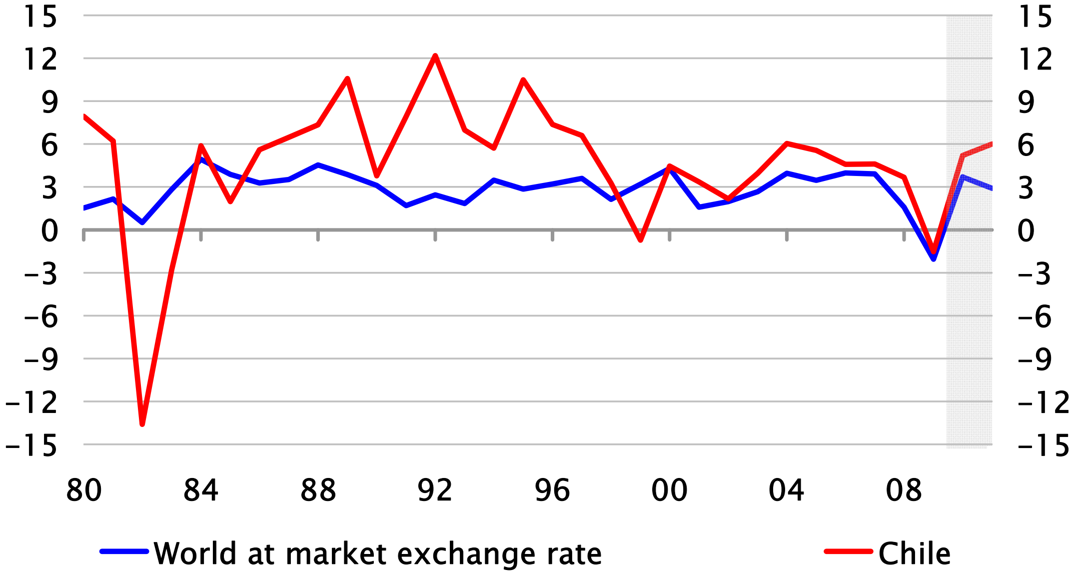
Marcel, M., M. Tokman, R. Valdés and P. Benavides (2001), "Balance estructural: la base de la nueva regla de política fiscal chilena," *Economía Chilena*, vol. 4, No. 3.

[3] For a review of the Chilean experience, see Cowan and De Gregorio (2007). The only empirical study that found some effects of reducing the extent of the appreciation is Edwards and Rigobon (2009). However, the magnitude of such effect is small, since the elimination of capital controls from its maximum would have appreciated the exchange rate between 2 and 2.5%. In any case, it is useful to recall that the highest real exchange rate appreciation in the last 20 years in Chile occurred in 1997, the year that featured capital controls, massive reserve accumulation, an exchange rate band and high interest rates.

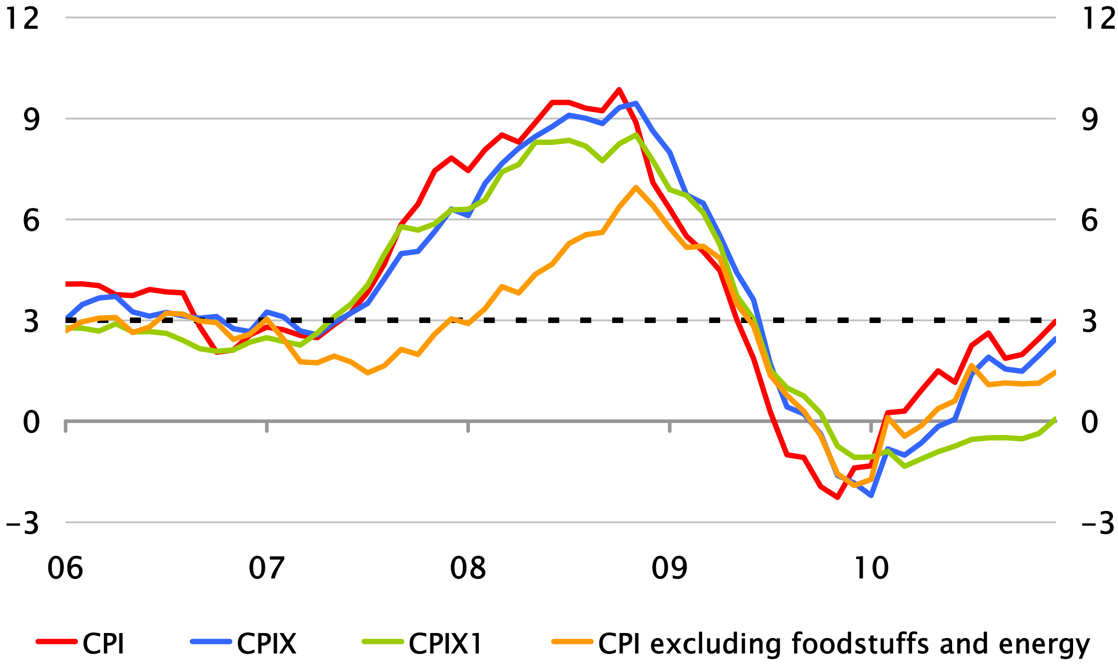
Figure 1
World growth (*)
(anual change, percent)



(*) Gray area denotes forecast published in the December's Monetary Policy Report. For Chile, considers the midpoint of the projected growth range in 2011.

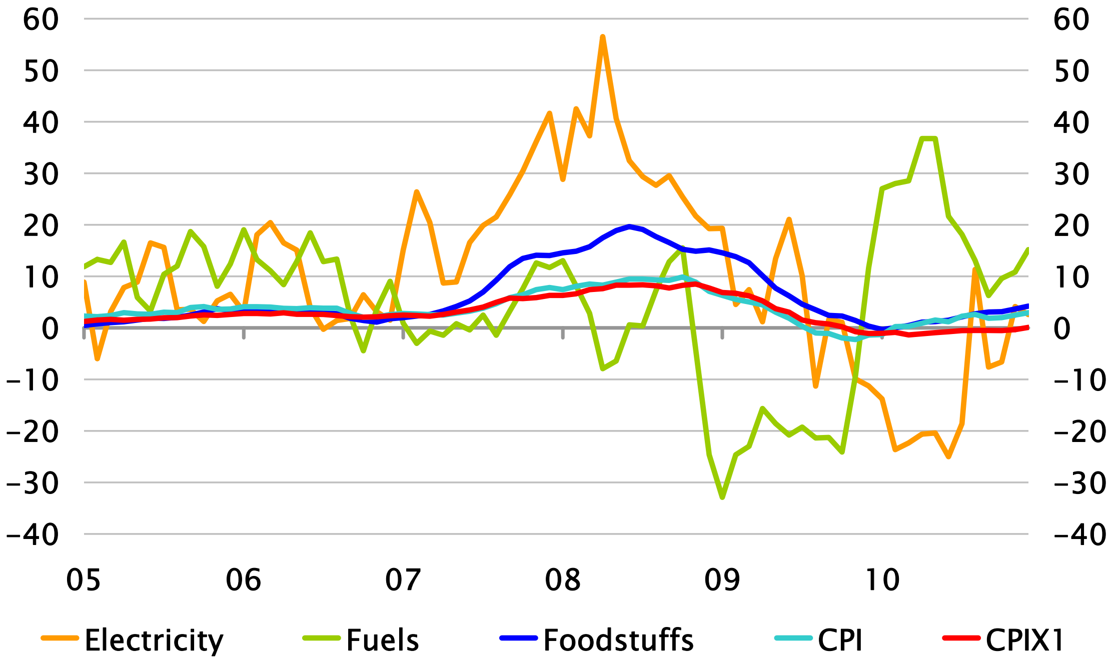
Sources: Central Bank of Chile and IMF.

Figure 2
Inflation indicators
(annual change, percent)



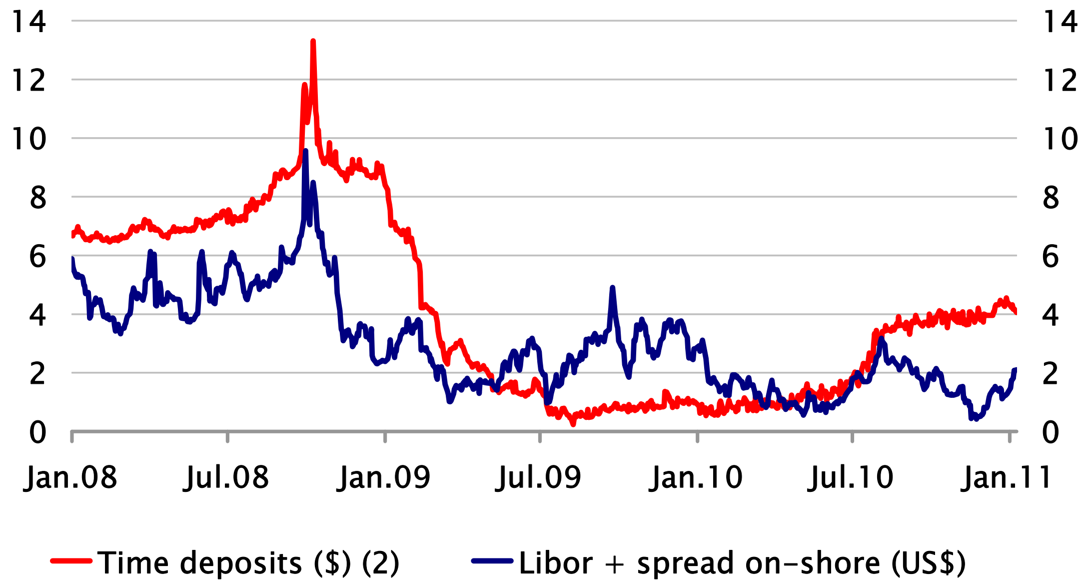
Sources: Central Bank of Chile and National Statistics Bureau.

Figure 3
Inflation by components
(annual change, percent)



Sources: Central Bank of Chile and National Statistics Bureau.

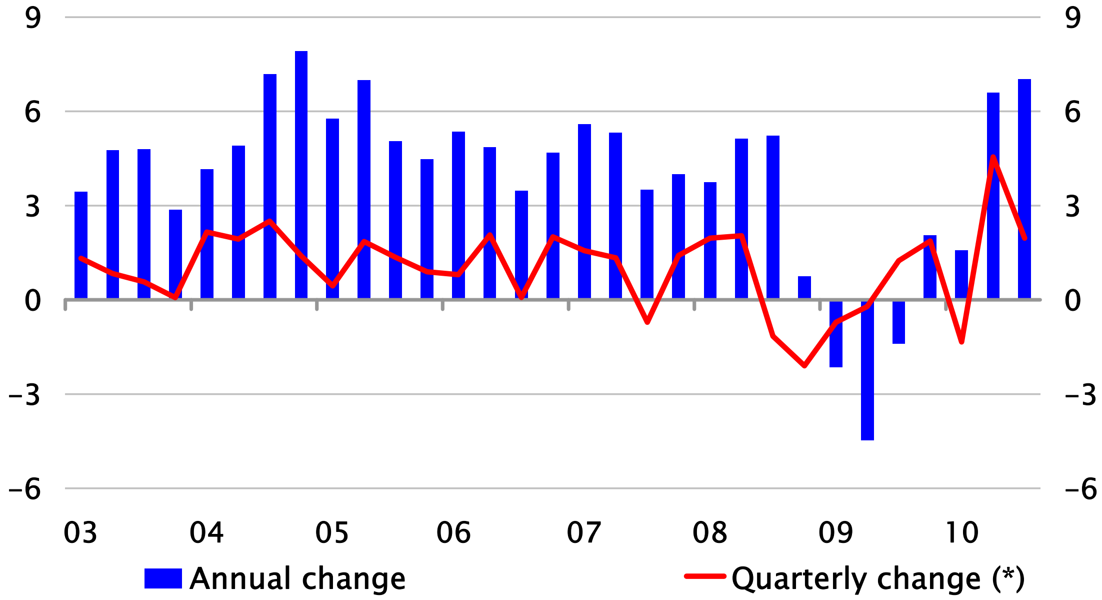
Figure 4
Domestic market rates in US$ and CLP (1)
(percent)



(1) 90 days. (2) Traded on the Chilean Stock Market.

Sources: Central Bank of Chile and Bloomberg.

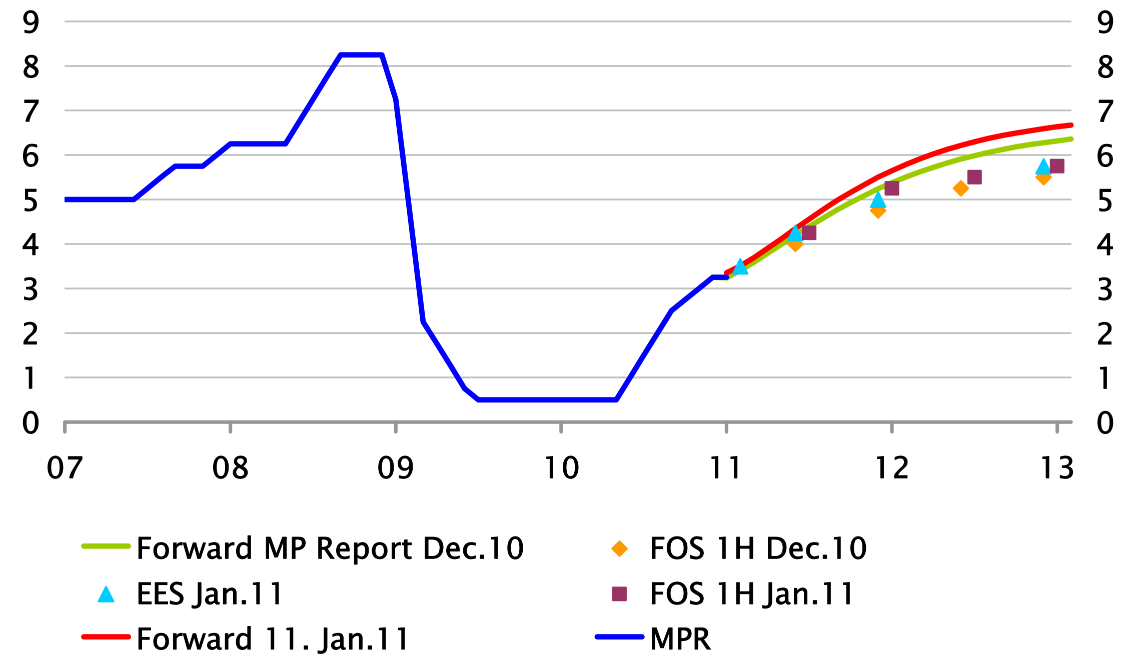
Figure 5
Gross domestic product
(percent)



(*) Seasonally-adjusted series.

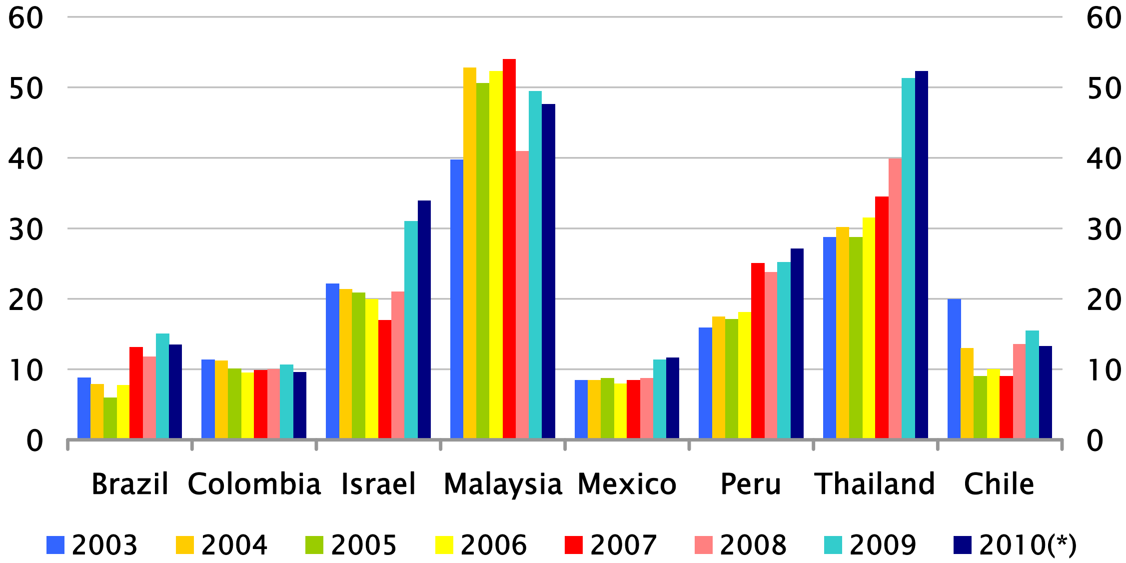
Source: Central Bank of Chile.

Figure 6
Monetary Policy Rate and expectations
(percent)



Source: Central Bank of Chile.

Figure 7
International reserves to GDP
(percent)



(*) Growth forecast and last available data of international reserves as from the IMF. For Chile, GDP growth forecast from December 2010 Monetary Policy Report.

Sources: Central Bank of Chile and International Monetary Fund.